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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

FRANCIS LEVIEN and JANICE LEVIEN,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether taxpayers are "at risk" within the meaning of Section 465 of the Internal Revenue Code with respect to their *pro rata* assumed share of the recourse portion of a Partial Recourse Promissory note issued by a tenancy-in-common in which taxpayers are members.

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

Francis Levien and Janice Levien (the "Leviens" or "Petitioners") respectfully petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case. As is set forth below, the Eleventh Circuit's decision is in conflict with at least two decisions of the Sixth Circuit.

OPINIONS BELOW

The decision of the United States Court of Appeals for the Eleventh Circuit (App., *infra*, 1a-2a) dated January 22, 1996 is reported at 77 F.3d 497. The opinion of the Tax Court (App., *infra*, 3a-27a) dated August 2, 1994 is reported at 103

T.C. No. 9. The decision of the Tax Court (App., *infra*, 30a) was entered on December 13, 1994.

JURISDICTION

The United States Court of Appeals for the Eleventh Circuit entered its judgment on January 22, 1996 (App., *infra*, 28a-29a) pursuant to its jurisdiction to review decisions of the Tax Court. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 465 of the Internal Revenue Code (I.R.C. § 465), provides that a taxpayer shall not be considered at risk with respect to amounts protected against loss through non-recourse financing, guarantees, stop-loss agreements or other similar arrangements. I.R.C. § 465(b) states in pertinent part:

> (b) Amounts considered at Risk.—
>
> (1) In general.—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—
>
> (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and
>
> (B) amounts borrowed with respect to such activity (as determined under paragraph (2)).
>
> (2) Borrowed amounts.—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in activity to the extent that he—
>
> (A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

. . .

(4) Exception—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through non-recourse financing, guarantees, stop loss agreements or other similar arrangements.

STATEMENT OF THE CASE

This Petition for a Writ of Certiorari involves a decision by the Eleventh Circuit affirming the Tax Court's denial of Petitioners' tax deductions from an equipment leasing transaction in which they invested.

This case involves a challenge by the IRS to a typical computer sale and lease transaction. Billions of dollars have been invested in such transactions in reliance on the assumption that the transactions would result in allowance of deductions and tax credits. However, the IRS contended, and the Tax Court and Eleventh Circuit held, that the transaction violated the "at-risk" rules set forth in Section 465 of the Internal Revenue Code (sometimes referred hereinafter as the "I.R.C." or the "Code"). Section 465 provides that a taxpayer shall not be considered "at risk" with respect to amounts protected against loss through non-recourse financing, guarantees, stop-loss agreements or other similar arrangements. Additionally, the IRS contended, and the Tax Court further held, that the transaction was tax-motivated as defined in I.R.C. § 6621(c) and

thus, the Leviens were held liable for the increased rate of interest imposed under that section of the Tax Code. In contrast to these findings, the parties stipulated that the transaction had economic substance, that the Leviens reasonably expected to make an economic profit and that the Leviens shared the benefits and burdens of the ownership of the computer equipment. The Eleventh Circuit upheld the decision of the Tax Court. (App., *infra*, 2a).

In December of 1983, the Leviens, acting as tenants-in-common with other investors under the name "Equi-TIC 83" entered into a computer purchase and leaseback transaction, involving various computer mainframes and peripherals. While the transactions are complicated, in substance affiliates of Equilease Corporation ("Equilease"), Equilease Equipment Brokerage C.V. ("C.V.") and Equilease Associates III Limited Partnership ("Associates") purchased computer equipment on lease to end-users in Europe. Equilease then sold the equipment to Aardan Leasing Corporation ("Aardan") for cash and promissory notes, and Aardan re-sold the equipment to the tenants-in-common, including the Leviens, also for cash and promissory notes. The equipment was then leased to Equilease's affiliates subject to end-user leases, and if all went according to plan the rents were to amortize the notes.

The Leviens, pursuant to a purchase agreement (the "Purchase Agreement") between themselves and Aardan, purchased five (5) units of undivided interests in computer equipment from Aardan. The Leviens' investment included (i) $11,250.00 cash at closing; (ii) a $21,875.00 full recourse promissory note (the "First Short Term Note"); (iii) a $21,875.00 full recourse promissory note ("Second Short Term Note") and (iv) a $488,750.00 Partial Recourse Promissory Note ("Long Term Note").

The IRS conceded that the Leviens were "at risk" pursuant to Section 465 of the I.R.C. with respect to the full amount of their cash investment, and the principal and interest on the

First and Second Short Term Notes. The crux of the issue is whether the Leviens were also "at risk" on any portion of the Long Term Note.

The Leviens contend that they were in fact "at risk" on the Long Term Note because they were the obligors of last resort in the event the "worst case scenario" came to pass. That worst case scenario involves (i) a default in incoming rent from either C.V. or Associates, (ii) depriving the Leviens of cash flow to pay their note to Aardan, (iii) while Aardan simultaneously seeks to collect the note from the Leviens. This risk is also a "realistic possibility." The risk of default is the most common and significant risk in any commercial finance transaction, and it is a risk which economic participants spend the most time planning and guarding against in such transactions—not always successfully. In the context of commercial finance, the "worst case scenario" of default is also a "realistic possibility"—as are the consequences of the possibility of default for the obligor of last resort.

A. Decisions Below

The United States Tax Court in its decision dated August 2, 1994, 103 T.C. No. 9, (App., *infra*, 3a-27a) held that the Leviens had not established that there was any realistic possibility that they would be subject to economic loss as a result of their long-term purchaser note, and thus held that the Leviens were not at risk pursuant to Section 465(b)(4) of the I.R.C.

The United States Court of Appeals for the Eleventh Circuit in a *per curiam* opinion dated January 22, 1996, affirmed the Tax Court's decision. (App., *infra*, 1a-2a).

REASONS FOR GRANTING THE PETITION

The decision of the Eleventh Circuit conflicts with the Sixth Circuit's decisions in *Emershaw v. Commissioner*, 949

F.2d 841 (6th Cir. 1991), and *Martuccio v. Commissioner*, 30 F.3d 743 (6th Cir. 1994). In addition to a split among the Circuit Courts, conflicting decisions exist in the Tax Court. Therefore, guidance from this Court is appropriate. This case provides the Court an opportunity to create consistency among the Circuits and within the Tax Court.

A. THE ELEVENTH CIRCUIT'S APPLICATION OF SECTION 465 OF THE INTERNAL REVENUE CODE CONFLICTS WITH THE SIXTH CIRCUIT'S *EMERSHAW* AND *MARTUCCIO* DECISIONS

The Eleventh Circuit's decision is in conflict with the decisions of the Sixth Circuit. In *Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991), and in *Martuccio v. Commissioner*, 30 F.3d 743 (6th Cir. 1994), the Sixth Circuit faced leasing transactions virtually identical with the one in this case. The Sixth Circuit found in both cases that the taxpayer was "at risk" for the recourse portion of the installment note issued to the parallel party to Aardan in this case. The Sixth Circuit applied the "worst case scenario" to determine if there was risk, and found that if the equivalent of C.V. or Associates here went bankrupt and stopped making rent payments to the taxpayer, the taxpayer would have had to expend his own money to pay the monthly payments on the installment note, at least to the extent of the recourse portion of the note.

The Sixth Circuit emphasized in *Emershaw* that if the party similar to C.V. or Associates "becomes insolvent," taxpayers "will be called upon to satisfy the terms of the partial recourse note. Therefore, the investment is at risk." 949 F.2d at 848.

Likewise, in *Martuccio* the Sixth Circuit also held that a leasing transaction identical to this one satisfied the "at risk" rules. Changing only the names to make them correspond to the participants in this case, the Sixth Circuit in *Martuccio* said the following:

> Using the same scenario set forth in *Emershaw*, it is clear that [Levien] was "at risk" for the recourse portion of the installment note issued to [Aardan]. If [C.V. or Associates] goes bankrupt, renounces its Lease, and stops making rent payments to [Levien], [Levien] would have to expend his own money to pay the monthly payments on the installment note due [Aardan], at least to the extent of the recourse portion of the note. As in *Emershaw*, if [C.V. or Associates] becomes insolvent because the end-users stop paying rent or for some other reason, [Levien] will be called on to satisfy the terms of the partial recourse note. Therefore, petitioner's investment is at risk.

30 F.3d at 749.

The Tax Court below expressly rejected the Sixth Circuit's holdings (App., *infra*, 13a), and the Eleventh Circuit was in "agreement with the reasoning of the Tax Court and affirm[ed] its judgment for substantially the reasons set out in its opinion." (App., *infra*, 2a).

Also arguably in conflict with the Sixth Circuit's decisions are decisions of the Second, Eighth and Ninth Circuits, as well as another decision of the Eleventh Circuit. *See*, *Waters v. Commissioner*, 978 F.2d 1310 (2d Cir. 1992), *cert. denied*, 507 U.S. 1018 (1993); *Young v. Commissioner*, 926 F.2d 1083 (11th Cir. 1991); *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990); and *Baldwin v. United States*, 904 F.2d 477 (9th Cir. 1990).[1]

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[1] Petitioner contends that *Waters*, *Moser* and *Young* are distinguishable from this case. In *Waters*, the court stated that there was a "virtual identity of the composition and control" of the two entities in that transaction analogous to C.V. and Associates and Aardan in this case. Because the entities were affiliated in *Waters*—which they are not in this case—it was unlikely on the facts of *Waters* that the entity analogous to C.V. and Associates would stop paying rent while simultaneously suing its affiliate to collect the note. This eliminates the risk.

In *Moser*, the leasing company in the same position as C.V. and Associates here permitted the company analogous to Aardan to satisfy its note

The *Baldwin* case generated a cogent dissent. Again changing the names to make them correspond to the parties in this case, the dissent in *Baldwin* first noted that the Leviens' note was fully recourse to Aardan. The dissent then asked what would happen if C.V. and Associates failed to pay the rent. The dissent concluded that Aardan might nevertheless seek to collect on its note from the Leviens, and that there were no "binding legal agreements" to protect the Leviens from having to make good on their obligation. 904 F.2d at 484. The dissenting opinion in *Baldwin* said:

> It is true that, so long as the rent payments are made, [Equi-TIC 83] has the funds to pay [Aardan]. But many things can go wrong and the key is that [Equi-TIC 83] and, in turn, the [Leviens], are neither absolved on the note nor protected against loss.

904 F.2d at 485. The *Baldwin* dissent rejected all of the key contentions made by the IRS in this case. The position taken by the dissent in *Baldwin* was the one adopted by the Sixth Circuit in *Emershaw* and *Martuccio*.

This diversity of views amongst the Circuits presents a classic circumstance for this Court to intervene. This is also not a purely theoretical Circuit split, involving an abstract principle of law. Literally billions of dollars of investor tax deductions are at stake, involving similar transactions under audit throughout the country. Anecdotal evidence exists that some taxpayers have actually moved to the Sixth Circuit to

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obligation to the leasing company by delivering the taxpayers' notes to the leasing company. 914 F.2d at 1044. Thus, in that case a default in rent would lead to an immediate set-off against the note, eliminating any risk. *Moser* would be the same as this case only if Aardan had satisfied its obligation to C.V. and Associates by delivering the Leviens' (and the other investors') Long Term Notes to C.V. and Associates.

Young is distinguishable in that the Court found the intermediate entity to be insubstantial and could be disregarded, saying that "Elmco" (here, Aardan) was "a straw man." The Court in *Young* also concluded that "the investors had merely assumed Elmco's nonrecourse liability to the third-party lessors." 926 F.2d at 1089.

try to take advantage of the favorable law there. Since two panels in the Sixth Circuit have adhered to the same view, there is no realistic possibility of resolution of the conflict among the Circuits without a decision from this Court.

It is troubling that, as a result of this Circuit split, a single transaction can have different tax consequences for different investors in that transaction depending upon whether the investors live in states which are located in different Circuits. Pursuant to I.R.C. § 7482(b)(1)(A), proper venue lies in the Circuit in which the petitioner resides. Thus, because the Leviens live in Florida, their decision in this case was appealed to the Eleventh Circuit. Another investor in the transaction might have resided in the Sixth Circuit, and he would be subject to a different tax outcome arising out of the very same investment. The strong federal policy in uniform nationwide tax treatment is impaired in the face of this result. Again this is not a theoretical concern; our law firm has actually encountered such situations in which geographically diverse investors have had different tax outcomes depending upon where they live. And as noted above, we know of some taxpayers who moved to the Sixth Circuit specifically to take advantage of the favorable rules there.

B. CONFLICTING AUTHORITY ALSO EXISTS IN THE TAX COURT ON THIS APPLICATION OF THE "AT RISK" RULES

This Circuit split has also helped to fuel a split in the Tax Court's own application of § 465(b)(4). The Tax Court has applied § 465(b)(4) to similar transactions as the one in this case and have has reached widely differing results. For example, *Melvin v. Commissioner*, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990); *Rubin v. Commissioner*, 58 T.C.M. (CCH) 25 (1987); and *Brady v. Commissioner*, 60 T.C.M. (CCH) 1415 (1990), were all cases where the Tax Court adopted the "worst case scenario" test to rule for the taxpayer. Other Tax Court cases holding for the taxpayer on virtually

identical facts are *Levy v. Commissioner*, 91 T.C. 838 (1988); *B&A Distributing Co. v. Commissioner*, 56 T.C.M. (CCH) 958 (1988); *Gefen v. Commissioner*, 87 T.C. 1471 (1986); *Abramson v. Commissioner*, 86 T.C. 360 (1986); and *Ockels v. Commissioner*, 54 T.C.M. (CCH) 785, 799-800 (1987).

On the other hand, other Tax Court cases involving identical facts have held for the IRS. *See, e.g., Thornock v. Commissioner*, 94 T.C. 439 (1990); *Van Roekel v. Commissioner*, 56 T.C.M. (CCH) 1297 (1989), *appeal dismissed*, 905 F.2d 80 (5th Cir. 1990) (*per curium*); and *Klagsbrun v. Commissioner*, 55 T.C.M. (CCH) 1519 (1988), where the Tax Court held that the taxpayer was not "at risk."

While ordinarily this Court does not grant *certiorari* to resolve a split in the courts below the level of the Court of Appeals, the Tax Court has nationwide jurisdiction. Because of the split in the Circuits, and amongst the judges of the Tax Court, consider the conundrum facing a Tax Court judge who faces multiple cases involving different taxpayers from different Circuits all arising out of the same investment. It is common in the Tax Court for all cases arising out of a particular transaction to be consolidated, regardless of the residence of the different taxpayer-investors. That Tax Court judge may feel compelled to rule one way for some taxpayers and a different way for others, in the same consolidated case arising out of the same transaction, depending on where the taxpayer resides and so to which Circuit that taxpayer's decision may be appealed. And, if the Tax Court judge has a taxpayer who resides in a Circuit which has not yet spoke on this issue, he cannot rely on the decisions of his brethren, because the Tax Court's own decisions are in such disarray.

We submit that when there is a split both amongst the Circuits, and amongst the judges of the Tax Court, the uniform nationwide application of federal tax law is sufficiently endangered that review by this Court is warranted. Thousands upon thousands of taxpayer-investors, involving literally bil-

lions of dollars of tax deductions, have a stake in this Court's resolution of the split in authority.

CONCLUSION

The petition for a Writ of Certiorari should be granted.

Dated: April 15, 1996

Respectfully submitted,

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APPENDIX

IN THE UNITED STATES COURT OF APPEALS

FOR THE ELEVENTH CIRCUIT

No. 95-4002
Tax Court No. 9006-90

FRANCIS AND JANICE LEVIEN,

Petitioners,

—VS.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appeal From A Decision of the
United States Tax Court

(January 22, 1996)

Before TJOFLAT, *Chief Judge*, RONEY and CAMPBELL*,
Senior Circuit Judges.

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* Honorable Levin H. Campbell, Senior U.S. Circuit Judge for the First Circuit, sitting by designation.

PER CURIAM:

Petitioners-appellants Francis Levien ("taxpayer") and his wife, Janice, appeal from a judgment of the Tax Court denying them tax deductions from a computer equipment leasing transaction. *Levien* v. *Commissioner*, 103 T.C. 120 (1994). Relying in part on this court's opinion in *Young* v. *Commissioner*, 926 F.2d 1083 (11th Cir. 1991), the Tax Court held that whether a taxpayer is at risk pursuant to § 465(b)(4) depends on whether there is a realistic possibility of economic loss. Regarding the transaction at issue here, the Tax Court concluded that the taxpayer had not established that there was a realistic possibility of economic loss on his long-term note. The tax court, therefore, disallowed the taxpayer's deduction for loss and found the taxpayer liable for the increased rate of interest imposed under § 6621(c) for substantial underpayment of tax attributed to tax-motivated transactions. Having heard argument and carefully considered the briefs and the record, we find ourselves in agreement with the reasoning of the Tax Court and affirm its judgment for substantially the reasons set out in its opinion.

Affirmed.

UNITED STATES TAX COURT

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103 T.C. No. 9

Docket No. 9006-90

Filed August 2, 1994

FRANCIS AND JANICE LEVIEN,

Petitioners,

—vs.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

P purchased computer equipment from a middle entity and leased the equipment back to third parties that had originally conveyed the equipment to the middle entity. P's payment obligations on his long-term purchaser note to the middle entity were exactly offset by the rental payments owed to him by the third parties. Likewise, the payment obligations of the middle entity to the third parties were exactly offset by payments owed to it by P. An affiliate of the third parties guaranteed the lease payments to P.

Sec. 465, I.R.C., limits deductions for losses from certain activities to the amount for which the taxpayer is "at risk". Sec. 465(b)(4), I.R.C., provides that a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.

1. *Held*: The ultimate test for determining whether a taxpayer is at risk pursuant to sec. 465(b)(4) is whether there is a realistic possibility of economic loss. Based on the facts presented, P has not established that there was any realistic possibility that he would be subject to economic loss as a result of his long-term purchaser note.

2. *Held, further*, Ps are liable for the increased rate of interest imposed under sec. 6621(c), I.R.C., for substantial underpayments attributable to tax-motivated transactions. *Richard P. Swanson* and *Marc D. Teitelbaum*, for petitioners. *Bruce Wilpon* and *Patricia Beary*, for respondent.

OPINION

RUWE, *Judge*: Respondent determined deficiencies, additions to tax, and additional interest against petitioners as follows:

Year	Deficiency	Additions to Tax Sec. 6659	Additional Interest Sec. 6621(c)
1983	$89,609	$26,883	120% of the interest due on $89,609
1984	68,210	20,463	120% of the interest due on $68,210

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Respondent has conceded the additions to tax, and the parties have stipulated the outcome of certain issues. Only two issues remain for us to decide. Those issues arise in connection with losses claimed by petitioners from an investment by petitioner husband (hereafter petitioner) in a computer leas-

ing activity (sometimes, the activity). We must decide whether such losses are disallowed pursuant to section 465 and whether petitioners are liable for additional interest.

Background

The parties have submitted this case fully stipulated, pursuant to Rule 122(a). The stipulation of facts entered into by the parties and exhibits attached thereto are incorporated herein by this reference. Petitioners resided in Palm Beach, Florida, at the time they filed the petition herein. During the years in issue, petitioners, who were calendar year taxpayers, filed joint income tax returns. Following is a summary of certain relevant facts.

I. *Petitioner's Transactions*

On December 20, 1983, petitioner entered into an agreement to purchase five units of interest in certain computer equipment for a total purchase price of $543,750.[1] The seller of those units was a Delaware corporation, Aardan Leasing Corp. (Aardan). Petitioner paid for his units by delivering to Aardan both cash and notes. Petitioner paid cash of $11,250. He also executed two short-term notes (the short-term notes) and one long-term note (the long-term note) in favor of Aardan. The short-term notes were each in the principal amount of $21,875, with one due in April 1984 and the other due in January 1985. Petitioner's liability was not limited under

[1] Exhibit 11-K is entitled "Equipment Purchase Agreement". Exhibit A to that agreement states the purchase price of the equipment to be $500,000, yet calls for cash and notes equaling a stated 108.75 percent of that amount, or $543,750. Exhibit 23-W is entitled "Security Agreement". Section 1 thereof describes two short-term notes (described herein, *infra*, in the total amount of $43,750) that represent interest payments on a long-term note (also described *infra*). The parties have stipulated that petitioner paid $543,750 in cash and notes for the purchase of his interest in the computer equipment in question. We have found that petitioner agreed to pay $543,750 for that interest. We have based our finding on stipulation 20, notwithstanding the contradictory evidence in the stipulated exhibits.

either short-term note. The long-term note was in the principal amount of $488,750. Principal and interest on the long-term note were due and payable on December 31, 1998. Prepayment was mandatory, however, to the extent of certain proceeds received by petitioner in connection with his interest in the computer equipment (principally, rental payments received from a lease of the equipment). Petitioner's personal liability under the long-term note was limited to $325,000. The five units of interest petitioner purchased in the computer equipment gave him an approximately one-fortieth interest (2.665560 percent) in the equipment. Subsequent to agreeing to purchase his interest in the computer equipment, petitioner entered into a lease of that interest, as described below. On their 1983 and 1984 Federal income tax returns, petitioners claimed losses of $83,333 and $161,727, respectively, on account of such transactions.

II. *Preceding Sales*

The computer equipment in which petitioner acquired an interest from Aardan was acquired by Aardan in two transactions. In the first, on December 31, 1983, Aardan acquired computer equipment from a partnership, Equilease Associates III Limited Partnership (Associates), a Connecticut limited partnership. The purchase price of that equipment (the Associates equipment) to Aardan was $1,013,548. Aardan paid $22,805 in cash and delivered its note, in the principal amount of $990,743, for the balance. That note called for an immediate payment of $68,414, applicable to the first 2 years' interest, and mandatory prepayments, out of certain proceeds, with any balance of interest and principal due on December 31, 2003. The Associates equipment was acquired by Aardan subject to (1) certain liens created when Associates acquired that equipment, and (2) certain leases of the equipment to users thereof. On or before the day that Associates sold the Associates equipment to Aardan, Associates purchased that equipment from a corporation, Equilease Marketing Corp. At that time, the Associates equipment was under lease and sub-

lease to Chemco Leasing GmbH and Hessischer Rundfunk, respectively (foreign business organizations).

The second transaction by which Aardan acquired the computer equipment in question also occurred on December 31, 1983. Aardan acquired computer equipment from Equilease Equipment Brokerage C.V. (C.V.) (also a foreign business organization). The purchase price of that equipment (the C.V. equipment) to Aardan was $17,744,237. Aardan paid $399,245 in cash and delivered its installment note in the principal amount of $17,344,992 for the balance. That note called for an immediate payment of $1,197,736, applicable to the first 2 years' interest, mandatory prepayments, out of certain proceeds, with any balance of interest and principal due on December 31, 2003. As with the Associates equipment, the C.V. equipment was acquired by Aardan subject to (1) certain liens created when C.V. acquired that equipment, and (2) certain leases of the equipment to users thereof. On or before the day that C.V. sold the C.V. equipment to Aardan, C.V. purchased that equipment from various leasing companies in Europe. The C.V. equipment was already under lease when purchased by C.V.

III. *Lease by Petitioner*

On December 31, 1983, petitioner, along with the other owners of interests in the Associates and C.V. equipment (collectively, the tenants in common) retained an agent, Equitable Leasing Co., Inc. (Equitable), to act on their behalf in connection with certain contemplated leasing activities. On that same date, the tenants in common, through Equitable, leased both the Associates equipment and the C.V. equipment to Associates and C.V., respectively. The rental term in each case was from December 31, 1983, through June 30, 1991. The total rental due under the lease to C.V. was $25,457,997.54, with monthly payments of $94,303.18, from January 31, 1984, through December 31, 1985, and of $351,435.17, beginning January 31, 1986, and continuing for the next 65 months. The total rental due under the lease to

Associates was $1,454,158.08, with monthly payments of $5,386.64 from January 31, 1984, through December 31, 1985, and of $20,073.92, beginning January 31, 1986, and continuing for the next 65 months.

IV. *Related Agreements*

On December 31, 1983, Aardan and petitioner, by petitioner's agent, Equitable, entered into an agreement to secure petitioner's obligations to pay its notes to Aardan. Petitioner accorded to Aardan security interests in (1) his fractional interests in the computer equipment purchased from Aardan, and (2) his rights under the agreements to lease that equipment to Associates and C.V. Aardan had the right to collect the rent due petitioner under those agreements. Associates' and C.V.'s obligations to pay rent to the tenants in common (including petitioner) were secured by assignments of their rights to collect rent from their own lessees, respectively.

On December 31, 1983, petitioner, by petitioner's agent, Equitable, and a corporation named Equilease Corp. (Equilease) entered into two separate agreements, one with respect to the lease to Associates and one with respect to the lease to C.V.

Under those agreements, styled "Capitalization Agreement", Equilease agreed "to make all necessary loans, advances or capital contributions to C.V. and Associates, respectively, to ensure the payment by C.V. and Associates" of rents to the tenants in common. Equilease's obligations were contingent on Aardan's continuing to make payments on its notes to Associates and C.V. for purchase of the Associates and C.V. equipment, respectively.

Equilease is stipulated to be an "affiliate" of both C.V. and Associates.[2]

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[2] On brief, petitioners state that C.V. is a shell subsidiary of Equilease and that Associates is an "affiliate" of Equilease.

V. *Coincidence of Payments*

Monthly payments received pursuant to the rental obligations of Associates and C.V. by the tenants in common (including petitioner) equal the monthly obligation of the tenants in common to pay Aardan for the computer equipment, which sum also equals the monthly obligations of Aardan to pay Associates and C.V. for such equipment. Similarly, petitioner's percentage of the rental payments received from C.V. and Associates equals the prepayment that he was obliged to make to Aardan on the long-term note.

Discussion

At Risk

Section 465 limits losses allowable to an individual in connection with certain activities to the amount that the individual is "at risk" with regard to the activity at year-end. The activity here in question is one to which section 465 applies.[3] Sec. 465(c)(1)(C). Respondent agrees that petitioner was at risk with regard to (1) the cash he contributed to the activity, and (2) payments he made on the short-term notes.[4]

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[3] The parties agree that petitioner's computer sale and leaseback transaction had economic substance and that petitioner reasonably expected to make an economic profit from the transaction exclusive of tax benefits. In addition, the parties agree that petitioner shared the benefits and burdens of ownership of the computer equipment.

[4] In their briefs, the parties have proposed various findings of fact. With regard to the short-term notes, there appears to be a conflict concerning the timing of petitioner's becoming at risk with regard to those notes. Respondent asks that we find that petitioner's amount at risk include "payments made" on the short-term notes. We assume that respondent is asking us to find that petitioner became at risk with regard to the short-term notes only as, and to the extent that, he made payments on those notes. Petitioners simply request a finding that petitioner was at risk with regard to the short-term notes. We interpret petitioners' request to be a request for a finding that petitioner became at risk with regard to the short-term notes at the time he executed those notes. Neither respondent's notice of deficiency nor the pleadings address this timing issue. Respondent's notice simply states that "gains

Respondent contends, however, that, with respect to the long-term note, petitioner was not at risk because he was protected against loss within the meaning of section 465(b)(4). Section 465(b)(4) provides:

> Exception.--Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

In determining whether a taxpayer is protected against loss within the meaning of section 465(b)(4), we look to see whether there is any realistic possibility that the taxpayer ultimately will be subject to economic loss on the investment at issue. *Thornock v. Commissioner*, 94 T.C. 439, 453 (1990).

> [T]he purpose of subsection 465(b)(4) is to suspend at risk treatment where a transaction is structured--by whatever method--to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable. A theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of this subsection. We must be guided by economic reality. * * * [*Waters v. Commissioner*, 978 F.2d 1310, 1315 (2d Cir. 1992), affg. T.C. Memo. 1991462 (quoting with approval *American Prin-*

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or losses are limited to your [petitioner's] amount at risk", while the petition equally simply says that respondent has made an erroneous determination, and that petitioner's amount at risk is not limited to his initial cash contribution. On brief, respondent sets forth as the only question presented with regard to the at-risk issue, whether the long-term note is part of petitioner's at-risk amount. The stipulation of facts entered into by the parties leads us to believe that the short-term notes were paid in full, the first in 1984, and the second in 1985. We interpret respondent's failure to state any question with regard to the timing issue concerning the two short-term notes as a concession of any issue raised by the seeming conflict in the proposed findings of fact. We have found the short-term notes to have been part of the purchase price petitioner agreed to pay for his interest in the computer equipment. We will treat petitioner as becoming at risk with regard to the two short-term notes as of the date he executed them, Dec. 20, 1983.

ican Principals Leasing Corp. v. United States, 904 F.2d 477, 483 (9th Cir. 1990)).]

The question presented is one of fact, and petitioners bear the burden of proof. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).[5] With regard to leasing activities, we scrutinize the economic reality of the transaction, focusing in particular upon the relationships between the parties, whether the underlying debt is nonrecourse, the presence of offsetting payments and bookkeeping entries, the circularity of the transaction, and the presence of any payment guarantees or indemnities. See *Waters v. Commissioner*, 978 F.2d 1310, 1316-1317 (2d Cir. 1992), affg. T.C. Memo. 1991-462; *Young v. Commissioner*, 926 F.2d 1083, 1088 (11th Cir. 1991), affg. T.C. Memo. 1988-440; *Moser v. Commissioner*, 914 F.2d 1040, 1049-1050 (8th Cir. 1990), affg. T.C. Memo. 1989-142; *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990); *Thornock v. Commissioner*, *supra* at 453. No single feature of the transaction generally will control. *Thornock v. Commissioner*, *supra* at 449.

We find no significant difference between the facts in this case and those in the cases cited above. For example, *Young v. Commissioner*, *supra*, involved similar sale/leaseback transactions, whereby the taxpayers purchased computer equipment from a middle entity that purchased the equipment from third parties to which the taxpayers leased the equipment. The rental payments in *Young* were equal to or in excess of the payments required under the taxpayers' purchase agreements to the middle entity. Based on these factors, the Court of Appeals for the Eleventh Circuit held that the taxpayers were not at risk under section 465(b)(4).[6] As stated by the Court of

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[5] Petitioners' burden of proof remains unchanged despite the fact that this case was fully stipulated. Rule 122(b); *Borchers v. Commissioner*, 95 T.C. 82 (1990), affd. on other issues 943 F.2d 22 (8th Cir. 1991).

[6] Appeal in the instant case lies to the Court of Appeals for the Eleventh Circuit. See *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

Appeals, "The chain of 'payments' could either continue as bookkeeping entries or cease, and there would be no actual circumstance upon which a demand for a payment would be made. See *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990)". *Id.* at 1088. Likewise, in *Thornock v. Commissioner*, *supra* at 451, this Court found that taxpayers involved in a similar computer leasing structure were not at risk due primarily to the existence of guarantees, the offsetting nature of lease and note payments, and the nonrecourse nature of the underlying debt.

In the instant case, all the important elements relied upon in the previously cited cases are present. All monthly obligations were exactly offset, including the rental obligations of C.V. and Associates to the tenants in common (including petitioner), petitioner's obligations to Aardan, and Aardan's obligations to C.V. and Associates. The payments simply self-extinguished via offsetting bookkeeping entries. The master leases (evidencing rental payments due from C.V. and Associates), the long-term notes (evidencing installment obligations to Aardan from the tenants in common), and the purchaser notes (evidencing Aardan's obligations to C.V. and Associates) commenced on the same date and were to terminate on the same date. As in the previous cases, the transaction was circular, with a middle entity (Aardan) connecting the taxpayer and third-party lessees (C.V. and Associates). Thus, it was highly unlikely that any one of the parties would refuse to meet an obligation. As stated in *American Principals Leasing Corp. v. United States*, *supra* at 483, "if one party failed to 'pay', he could only expect a chain reaction resulting in his obligor's ceasing 'payment' as well." In addition, the rental payments of C.V. and Associates were guaranteed by an affiliate, Equilease.

Finally, as in both *Young* and *Thornock*, petitioners on brief concede that the underlying financing used by the original leasing companies, from whom C.V. and Associates purchased the computer equipment, was nonrecourse. See also *Moser v. Commissioner*, *supra* at 1050.

The relationships between the parties to the transaction, as evidenced by the master leases, the purchaser notes, and the long-term notes, show that great pains were taken to ensure that no economic loss would be sustained by the tenants in common as a result of their execution of the long-term note. In paragraph 18 of the master lease agreements, Associates and C.V. agreed to indemnify the tenants in common against any and all loss incurred for, or by reason of the leasing, of the equipment.[7] The tenants in common were explicitly provided with all the usual legal remedies in the event that one of the other parties defaulted on its obligations, including the ability to sue Aardan for breach of warranty and C.V. and Associates for nonpayment.

Petitioners request that we analyze the facts herein based on the "worst case scenario" test that was articulated by the court in *Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991), affg. T.C. Memo. 1990-246. They contend that, based upon this test--as opposed to the "realistic possibility of economic loss" analysis upon which we base our decision--petitioner's transaction did not constitute a loss-protection scheme or a prohibited "other similar arrangement". We previously addressed a similar argument in *Wag-A-Bag Inc. v. Commissioner*, T.C. Memo. 1992-581, in which we determined that, "whichever standard is used, the ultimate decision rests upon the substance of the transaction in light of all the facts and circumstances.[8] We continue to hold to the view—expressed in *Wag-A-Bag*--that, under section 465(b)(4), economic reality should be the touchstone of the analysis.[9]

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[7] Indeed, according to the promotional letter for the transaction, Equilease went so far as to agree to repurchase the equipment at the price paid by the tenants in common plus a reasonable interest factor if certain potential tax law changes retroactively rendered the transaction unprofitable.

[8] But see *Martuccio v. Commissioner*, ___ F.3d ___ (6th Cir., July 28, 1994), revg. and remanding T.C. Memo. 1992-311.

[9] While our opinion in *Wag-A-Bag, Inc. v. Commissioner*, T.C. Memo. 1992-581, downplays the differences between application of the "worst case scenario" and "realistic possibility of economic loss" tests, other courts have viewed the distinctions between the two as more fundamental and have

Petitioners do not deny that the individual factors discussed above were present in petitioner's leasing transactions. However, petitioners attempt to obscure what appears to be the economic reality of the transactions by arguing that each piece of the transactions, standing alone, did not protect the tenants in common against loss. Petitioners also attempt to distinguish the numerous cases with similar facts and unfavorable conclusions on the basis of factors present or not present in those other cases. We reject these arguments. We adhere to our position that it is the substance of the transaction, rather than the form, which is controlling and that substance is determined by looking at all the material facts. *Thornock v. Commissioner*, *supra* at 449. As stated above, we discern no material difference between the facts of this case and those in the numerous cases cited above.

In *Porreca v. Commissioner*, 86 T.C. 821, 838 (1986), we observed that while the legislative history of section 465 does not define what is meant by "other similar arrangements," the phrase "evidence[s] concern with situations in which taxpayers are effectively immunized from any realistic possibility of suffering an economic loss even though the underlying transaction was not profitable." We find this an apt description of petitioner's transactions. After consideration of all the elements described above, petitioners have failed to convince us that petitioner was not protected against loss within the meaning of section 465(b)(4).

Section 6621(c)

Respondent also seeks increased interest pursuant to section 6621(c). That section provides for an increase in the interest rate to 120 percent of the statutory rate on underpayments of

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rejected the application of the "worst case scenario" for purposes of sec. 465(b)(4). See *Waters v. Commissioner*, 978 F.2d 1310, 1315-1316 (2d Cir. 1992), affg. T.C. Memo. 1991-462; *Young v. Commissioner*, 926 F.2d 1083, 1089 n.14 (11th Cir. 1991), affg. T.C. Memo. 1988-440; *Moser v. Commissioner*, 914 F.2d 1040, 1049-1050 (8th Cir. 1990), affg. T.C. Memo. 1989-142; *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 482 (9th Cir. 1990).

tax if a substantial understatement is due to a tax-motivated transaction. Certain transactions are deemed to be "tax-motivated" by section 6621(c)(3), including any loss disallowed under section 465(a). Sec. 6621(c)(3)(A)(ii). Since we have concluded that the loss deductions in issue stemming from petitioner's long-term note to Aardan are disallowed under section 465(a), we also find that this was a tax-motivated transaction, and respondent is entitled to additional interest on the interest accruing on the portion of the underpayment attributable to such transaction after December 31, 1984.

Decision will be entered under Rule 155.

Reviewed by the Court.

HAMBLEN, PARKER, COHEN, SWIFT, GERBER, WRIGHT, PARR, WELLS, COLVIN, BEGHE, CHIECHI, and LARO, *JJ.*, agree with this majority opinion.

HALPERN, *J.*, concurring:

I. *Introduction*

I concur in the result reached by the majority. I write separately only because I think that the majority has unnecessarily looked too far to see whether petitioner husband (petitioner) was protected against loss within the meaning of section 465(b)(4). The majority has determined that, with respect to the long-term note, petitioner was protected against loss through an "other similar arrangement", as that term is used in section 465(b)(4). Majority op. pp. 15-16. In its analysis, the majority has totally disregarded the nonrecourse aspect to the long-term note and accorded only make-weight status to the rent guarantees. "Nonrecourse financing" and "guarantees" are specifically enumerated in section 465(b)(4). Because petitioners have conceded that petitioner was not at risk with respect to the nonrecourse portion of the long-term

note ($163,750), and have argued that the rent guarantees should be disregarded in their entirety, I see no need to find or cumulate factors as the majority has done in order to determine whether petitioner was protected against loss through an arrangement that is *similar to* either nonrecourse financing, a guarantee, or a stop-loss agreement. Petitioners have failed to show that the protection against loss afforded petitioner by the nonrecourse financing and guarantees is insufficient to eliminate any risk otherwise attendant to petitioner's investment of the proceeds of the long-term note. I would so hold.

II. *Nonrecourse Financing*

Where a note has been partially recourse, we have looked no further to determine that, to the extent of the nonrecourse portion of the note, the taxpayer was not at risk for purposes of section 465(b). See, e.g., *B & A Distributing Co. v. Commissioner*, T.C. Memo. 1988-589 (limited recourse promissory note); cf. *Berger v. Commissioner*, T.C. Memo. 1994-298 (attempt to add recourse feature to nonrecourse note).

III. *Guarantees*

A. *The Guarantee*

Equilease, under the Capitalization Agreements, guaranteed Associates' and C.V.'s obligations to pay rent to the tenants in common (including petitioner). To quote the majority:

> Equilease agreed "to make all necessary loans, advances or capital contributions to C.V. and Associates, respectively, to ensure the payment by C.V. and Associates" of rents to the tenants in common. Equilease's obligations were contingent on Aardan's continuing to make payments on its notes to Associates and C.V. for purchase of the Associates and C.V. equipment, respectively. [Majority op. p. 8.]

B. *Precedent*

There is no case in which we have explored the meaning of the term "guarantee", as that term is used in section 465(b)(4). A dictionary definition includes the following: "A pledge that something will be performed in a specified manner. * * * A guaranty by which one person assumes responsibility for paying another's debts or fulfilling another's responsibilities." American Heritage Dictionary of the English Language (3d ed. 1992). Nevertheless, guarantees and similar arrangements have played a role in our determining that a taxpayer was not at risk on account of section 465(b)(4). For example: In *Thornock v. Commissioner*, 94 T.C. 439, 451 (1990), rent guarantees were a primary factor leading us to find that "no realistic possibility existed that the * * * [taxpayers] would be ultimately liable to make any payments on * * * [their] debt obligations". In *Capek v. Commissioner*, 86 T.C. 14 (1986), we dealt with a coal mining program that required the taxpayer in question to pay certain advance royalties. A mining company was to pay to the taxpayer penalties if the mining company failed to mine the land leased by the taxpayer. We stated that it was obvious from the facts of the case that "the effect of the penalty provision was to protect an investor from any loss on the recourse note executed by him in favor of * * * [a lender who advanced the required advance royalty payments]". *Id.* at 52. We concluded that "the penalty provisions in the mining contracts were stop loss agreements or other similar arrangements within the meaning of section 465(b)(4)." *Id.* at 53.

C. *Eliminating the Risk of Default*

In *Thornock v. Commissioner*, *supra*, and *Capek v. Commissioner*, *supra*, we examined the guarantees there in question with an eye to determining whether the taxpayer had insured against his liability to repay borrowed funds contributed by him to the activity. Such a determination is appropriate because there is no doubt that, if a taxpayer borrows

funds for use in a section 465 activity, and obtains insurance against his personal obligation to repay those funds, he will not be considered at risk with regard to those funds for purposes of section 465(b)(2). See sec. 465(b)(4).[1] Presumably, the taxpayer will not be considered at risk because he has eliminated the economic risk to himself of a deficiency judgment against him should he default on his personal obligation. The economic risk that he has eliminated is the risk that, upon his default, he would be called upon to make up the difference between his indebtedness and the amount realized from a sale of the property securing that indebtedness. That risk (the risk of default) has been shifted to the insurer. Indeed, when the Commissioner has argued that a taxpayer is protected against loss with respect to a particular debt obligation, we have characterized our inquiry under section 465(b)(4) as follows: "who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt[?]". *Levy v. Commissioner*, 91 T.C. 838, 869 (1988).

D. *Assuring the Value of the Investment*

Most investments require at least some of the investor's own funds (equity capital) in addition to borrowed funds (debt capital). Section 465 clearly contemplates that an investor may be at risk with respect to equity capital. Compare sec. 465(b)(1)(A) with (B). Section 465(b)(4) just as clearly contemplates that an investor will not be considered at

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[1] Sec. 465 was added to the Code by sec. 204(a) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1531. In the Senate, S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49 (S. Rept. 94-938), accompanied H.R. 10612, which became the Tax Reform Act of 1976. In pertinent part, S. Rept. 94-938 states:

> if a taxpayer is personally liable on a mortgage but he separately obtains insurance to compensate him for any payments which he must actually make under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed. * * * [Fn. ref. omitted.]

1976-3 C.B. (Vol. 3) 88.

risk to the extent that his equity capital is protected against loss.[2] Where an investment consists in whole or in part of debt capital, it is natural to look at the liability side of the balance sheet, and ask whether there is a realistic risk of default if the investment goes sour. Unless the debtor's protection from the risk of default is blatant (e.g., he has obtained mortgage insurance or the debt is nonrecourse), it may be necessary to weigh numerous factors, including guarantees, to determine the reality of such risk. See, e.g., *Thornock v. Commissioner*, *supra* at 448-449 (1990) (to determine whether "other similar arrangements" effectively immunized highly leveraged investors from any realistic possibility of suffering an economic loss, we analyzed "the substance and commercial realities of all material aspects of the transaction."). Such an examination is perfectly appropriate. Nonetheless, in determining a taxpayer's amount at risk, where asset value or investment return is directly protected against loss by a guarantee or other arrangement proscribed by section 465(b)(4),

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[2] S. Rept. 94-938, *supra*, 1976-3 C.B. (Vol. 3) 87, confirms the application of sec. 465(b)(4) to equity capital:

> Also, under these rules, a taxpayer's capital is not "at risk" in the business, even as to the *equity* capital which he has contributed[,] to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer.
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> * * *
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> In livestock feeding operations, for example, some commercial feedlots have offered to reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such "stop loss" orders, the investor is to be considered "at risk" (for purposes of this provision) only to the extent of the portion of his capital against which he is not entitled to reimbursement. Similarly, in some livestock breeding investments carried on through a limited partnership, the partnership agrees with a limited partner that, at the partner's election, it will repurchase his partnership interest, at a stated minimum dollar amount (usually less than the investor's original capital contribution). In situations of this kind, the partner is to be considered "at risk" only to the extent of the portion of the amount otherwise at risk over and above the guaranteed repurchase price. [Fn. ref. omitted; emphasis added.]

and focusing only on the effect of such guarantee or other arrangement, the character of the taxpayer's investment--whether debt capital or equity capital--can have little (if any) consequence. Thus, in some cases, such as this, a guarantee of asset value or investment return may eliminate the need to consider additional factors, since the guarantee, itself, is sufficient to eliminate all risk of loss with respect to the amount (whether debt financed or equity financed) in question. Indeed, in *Cooper v. Commissioner*, 88 T.C. 84 (1987), we confronted certain lessor-borrowers who were personally liable with regard to purchase money indebtedness incurred to purchase the leased property, but who had options to put that property, which secured their indebtedness, to the lessee at the end of the lease term for amounts approximately equal to the remaining balances of their indebtedness. We said:

> These petitioners, through their put options, were protected from economic loss [the risk of default] from the inception of their transactions. * * * Therefore, their obligations under the notes may not be added to their amounts at risk. * * *

Id. at 112-113.

E. *Rent Guarantees*

The principal financial obligation of a lessee is to pay rent. The financial value of a lease is the present value of the rent stream expected over the unexpired term of the lease. Generally, a guarantee of rent adds to the financial value of a lease. If the guarantee (1) can be relied upon and (2) is unconditional, then the financial value of the lease, together with the value of the guarantee (together, the guaranteed value of the lease), will equal the financial value of a lease to a lessee presenting no risk of lease default. The guarantee shifts the risk of lease default to the guarantor. Because of the guarantee, the lessor can disregard that risk in determining what his loss might be should the activity in which the leased property is used fail. If the leased property has been purchased

with debt capital, and should the activity fail (e.g., because of the lessee's default), then the guarantee assures that the guaranteed value of the lease will be available to repay the indebtedness before any charge need be made to capital. To the extent of the guaranteed value of the lease, the risk of default on the loan has been shifted to the guarantor. To that extent, the guarantee may provide a sufficient basis for us to find that the taxpayer is not at risk with regard to borrowed funds used to purchase the leased property. See sec. 465(b)(4); *Cooper v. Commissioner*, *supra*; *Capek v. Commissioner*, 86 T.C. 14 (1986).

F. *Application to the Facts at Hand.*

Petitioner was a borrower with regard to the activity here in question. He incurred a purchase money indebtedness to Aardan in connection with his acquisition of an interest in the Associates and C.V. equipment. The long-term note indebted petitioner to pay Aardan the principal amount of $488,750. The long-term note was not due until December 31, 1998. Nevertheless, prepayment was obligatory to the extent of fixed rent payments received from Associates and C.V. Petitioner's indebtedness was secured by (1) his fractional interests in the computer equipment purchased from Aardan and (2) his rights under the agreements leasing that equipment to Associates and C.V. Aardan had the right to collect the rent due petitioner under those agreements. Under the Capitalization Agreements, subject to certain conditions, Equilease agreed "to make all necessary loans, advances or capital contributions to C.V. and Associates, respectively, to ensure the payment by C.V. and Associates" of rents to petitioner.

A direct benefit to petitioner of the Capitalization Agreements was that some portion of the risk that Associates and C.V. would default on their obligations to pay rent was shifted from petitioner to Equilease. For reasons that I will make clear shortly, we may assume that Equilease was a reliable guarantor. Nevertheless, Equilease's guarantee was conditional, and we should inquire as to what was the guaranteed

value of the leases to Associates and C.V. To determine how much petitioner was, at any time, at risk on account of the long-term note, we should subtract from the then-remaining principal amount of that note the greater of (1) the guaranteed value of the leases or (2) the nonrecourse portion of petitioner's obligation. Before making those inquiries, however, I will address certain additional arguments made by petitioners on brief as to why the Capitalization Agreements do not give rise to guarantees encompassed within the language of section 465(b)(4).

G. *Common Commercial Practice*

On brief, petitioners argue strenuously that Equilease's guarantees of Associates' and C.V.'s rental obligations constituted "a common commercial practice", pursuant to which "it was clearly understood by all that Equilease was standing behind the [lessees]." Petitioners continue:

> For all intents and purposes the Tenants-in-Common contracted with the parent Equilease and not the subsidiaries. * * * It makes no sense for a parent's guarantee of its shell subsidiary's lease to be an impermissible guarantee where clearly there would be no violation of the "at risk" rule if the lease had been entered into with the parent directly.

In at least one respect, petitioners undoubtedly are correct. Had the tenants in common done no more than enter into a direct lease with Equilease, the strength of Equilease's credit alone would not have reduced the risk of nonpayment of rent to petitioner, so as to trigger the application of section 465(b)(4). See *Gefen v. Commissioner*, 87 T.C. 1471, 1503 (1986) ("nothing in section 465 * * * requires an owner of property to enter into a transaction with a party that is a poor credit risk in order to be 'at risk' within the meaning of section 465.").

Nevertheless, that is *not* how the present transaction was structured. In deciding the tax consequences of that transaction, we can only consider how the transaction was structured, and not how it might have been. In *Van Roekel v. Commissioner*, T.C. Memo. 1989-74, dismissed and remanded 905 F.2d 80 (5th Cir. 1990), we refused to disregard the separate legal identity of a corporate parent:

> Corporate law generally recognizes separate legal identities for the parent corporation and subsidiary, each responsible for its own debts even though both are part of a single business enterprise. Likewise, jurisdictions widely sanction the parent corporation's guarantee of its subsidiary's obligations, a credit device deemed to be in furtherance of the parent corporation's purposes because of its stock ownership. Thus, for purposes of applying section 465(b)(4), there is no reason for distinguishing a valid guarantee where the guarantor and principal debtor are parent corporation and subsidiary from one where the guarantor and principal debtor are not related. [Citations omitted.]

For the reasons stated in *Van Roekel*, I would not disregard the separate legal identities of Associates and C.V., on the one hand, and Equilease, on the other.

Moreover, nothing in section 465(b)(4) leads me to believe that, because it may be a "common commercial practice" for a parent to guarantee the obligations of a subsidiary, such guarantees are removed from concern under section 465(b)(4). Simply put, I cannot read into section 465(b)(4) a distinction between "bad" and "good" rent guarantees. Financial risk, not motive, is the determinative factor. Section 465 was added to the Code by section 204(a) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1531. In the Senate, S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, accompanied H.R. 10612, 94th Cong., 2d Sess. (1976), which became the Tax Reform Act of 1976. S. Rept. 94-938 simply indicates that insurance against casualties or tort liability is

not of a piece with insurance that immunizes an investor from his liability for debt capital contributed to a section 465 activity. S. Rept. 94-938, *supra*, 1976-3 C.B. (Vol. 3) 88. The principal financial risk associated with the activity petitioner engaged in (leasing) *is* the nonreceipt of rent. Clearly, that is the type of risk that Congress intended an investor to bear in order to be considered at risk with regard to a leasing activity. Finally, petitioners argue that, because no consideration was paid for Equilease's guarantee, Equilease was not an independent third party, on whose credit the tenants in common relied, independent of their reliance on Associates and C.V. (admittedly not superb credit risks). All petitioners are saying, however, is that the deal was priced (rent was determined) as if the lease were with Equilease rather than with Associates and C.V. The short answer to petitioners' claim is that we have decided *not* to engage in that fiction. From an economic point of view, the tenants in common are in the same position that they would have been had they (1) relied solely on the credit of Associates and C.V. (supposedly Equilease's subsidiaries) in pricing each lease and (2) paid Equilease to bear the risk of nonpayment of rent.[3] Petitioners have advanced no cogent reasons why Equilease's guarantees are not encompassed within the language of section 465(b)(4). Admittedly, I would, in effect, draw a line between lessors who rely solely on the credit of their lessees and lessors who rely in part on the credit of a third party. Cf. *Gefen v. Commissioner*, *supra*. That distinction, however, merely reflects the line that Congress drew in prohibiting guarantees and similar loss limitations in the first place:

> Under this concept, an investor is not "at risk" if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is

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[3] S. Rept. 94-938 indicates that, in such situation, the tenants in common would be in no different at risk position with regard to the guarantee of rental payments (viz, not at risk), but would be able to add to their amount at risk any payments from their own funds made to Equilease for such guarantee. 1976-3 C.B. (Vol. 3) 88.

> entitled to reimbursement for a part or all of any loss by reason of a binding agreement between himself and another person.

S. Rept. 94-938 (1976), *supra*, 1976-3 C.B. (Vol. 3) 87.

H. *Value of the Guarantees*

As stated, petitioner agreed to pay $543,750 for his interest in the activity. Petitioner could have lost money if the value of his interest declined below that amount. The amount he could have lost, however, was subject to certain limitations. The long-term note was only partially recourse. The *non*recourse portion was $163,750. Petitioner does not claim that he would have suffered any *additional* loss had the value of his interest in the activity declined (at least initially) below $163,750. Petitioner's potential for loss was, thus (initially), limited to $380,000. That sum ($380,000) is the difference between the amount he had agreed to pay ($543,750) and the nonrecourse portion of the long-term note ($163,750). Put another way, until petitioner had paid down some of the long-term note (reducing the nonrecourse portion), any *further* decline in the value of petitioner's interest in the activity *below* $163,750 would not have increased his potential for loss. The nonrecourse portion of the long-term note was a floor that limited the risk to petitioner of a fall in the value of his interest in the activity. Petitioner may have been subject to even less risk, however, because of Equilease's guarantee. Equilease's guarantee may have raised the level of the floor. If the guaranteed value of the leases exceeded $163,750, then the risk petitioner bore would have been less than $380,000. Thus, for instance, if the guaranteed value of the leases were $500,000, petitioner would initially have been at risk only to the extent of $43,750. With regard to determining the guaranteed value of the leases, S. Rept. 94-938 instructs us:

> Similarly, if a taxpayer is personally liable on a mortgage but he separately obtains insurance to compensate him for any payments which he must actually make

> under such personal liability, the taxpayer is at risk only to the extent of the uninsured portion of the personal liability to which he is exposed.[6] * * *
>
> [6] For purposes of this rule, it will be assumed that a loss-protection guarantee * * * or insurance policy will be *fully* honored and that the amounts due thereunder will be *fully* paid to the taxpayer. *The possibility that the party making the guarantee to the taxpayer * * * will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not * * * material * * **

S. Rept. 94-938, 1976-3 (Vol. 3) C.B. 49, 88 (emphasis added). Thus, we should not concern ourselves with Equilease's financial condition or the possibility that it will not fully honor its guarantee. See *Capek v. Commissioner*, 86 T.C. at 52-53; *Klagsbrun v. Commissioner*, T.C. Memo. 1988-364. Nevertheless, we should not disregard the fact that Equilease's guarantee was conditional. The guarantee was conditional on Aardan's continuing to make payments on its notes to Associates and C.V. Thus, the guaranteed value of the leases was somewhat less than the financial value of leases presenting no risk of lease default.[4] How much less, however, I cannot say.

Petitioners have made the tactical choice to argue that the guarantee is to be disregarded *in its entirety*; that clearly is not the proper course, however. As a result of petitioners' failure of proof, they have left us without guidance as to the guaranteed value of the leases. Lacking sufficient information to make our own estimate, cf. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), I would conclude that respondent is correct that, for the years in issue, on account of the guarantee, the guaranteed value of the leases was at least $488,750.

[4] I.e., the present value of the rent stream expected over the unexpired term of the lease, assuming a discount rate appropriate for a risk-free lease.

On the facts before us, petitioner was protected against a decline below $488,750 in the value of his interest in the activity. Of the $543,750 that petitioner agreed to pay for his interest in the activity, petitioner was at risk only to the extent of his cash contribution ($11,250) and the principal amount of the two short-term notes ($43,750). I would so find. Rule 142(a). Accordingly, I would sustain respondent's determination that petitioner was not at risk during the years in issue with respect to his $488,750 long-term note to Aardan.

CHABOT, *J*, agrees with this concurring opinion.

UNITED STATES COURT OF APPEALS

FOR THE ELEVENTH CIRCUIT

No. 95-4002
Tax Court No. 9006-90
Filed January 22, 1996
Miguel J. Cortez, Clerk

FRANCIS AND JANICE LEVIEN,

Petitioners,

—versus—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appeal From A Decision of the
United States Tax Court

(January 22, 1996)

Before TJOFLAT, *Chief Judge,*
RONEY and CAMPBELL*, *Senior Circuit Judges.*

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* Honorable Levin H. Campbell, Senior U.S. Circuit Judge for the First Circuit, sitting by designation.

JUDGMENT

This cause came to be heard on the transcript of the record from the United States Tax Court, and was argued by counsel:

UPON CONSIDERATION WHEREOF, it is now hereby ordered and adjudged by this Court that the decision of the Tax Court in this cause be and the same is hereby AFFIRMED;

It is further ordered that petitioners pay respondent the costs on appeal to be taxed by the Clerk of this Court.

Entered: January 22, 1996
For the Court: Miguel J. Cortez, Clerk

By: /s/ MATT DAVIDSON
Deputy Clerk

ISSUED AS MANDATE: March 15, 1996

UNITED STATES TAX COURT

Docket No. 9006-90

FRANCIS AND JANICE LEVIEN,

Petitioners,

—versus—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed August 2, 1994, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioners for the taxable years 1983 and 1984 in the amounts of $62,109.00 and $68,210.00, respectively;

That there are no additions to tax due from the petitioners for the taxable years 1983 and 1984, under the provisions of I.R.C. § 6659; and

That for the taxable years 1983 and 1984, $62,109.00 and $68.210.00, respectively, are substantial underpayments attributable to tax-motivated transactions, for purposes of computing the interest payable with respect to such amounts, pursuant to I.R.C. § 6621(c).

[Signed] ROBERT P. RUWE
Judge

Entered: December 13, 1994